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No. 47

In the Supreme Court of the United States

OCTOBER TERM, 1945

TALBOT MILLS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	3
Summary of argument	10
Argument:	
I. The court below properly affirmed the holding of the Tax Court since, viewing the transaction from any standpoint, it constitutes an issue of preferred stock	16
A. The provisions of the "registered notes" are frequent and authorized clauses familiar to preferred stock, and the circumstances surrounding their issue and their treatment since issue further confirm their character as stock	18
B. Whether the question presented is considered to turn on its special facts or whether it is considered to be a question of law, turning on the meaning of "indebtedness" as used in the statute, the court below and the Tax Court properly looked to the actualities of the situation in determining whether the corporate distributions were dividends or interest on indebtedness	28
II. The contract does not as a matter of law require the payment of interest	35
Conclusion	39

CITATIONS

Cases:	
Adams v. *Commissioner*, 5 T. C. No. 40	31
Bakers' Mutual Coop. Ass'n v. *Commissioner*, 117 F. 2d 27	20
Brown-Rogers-Dixon Co. v. *Commissioner*, 122 F. 2d 347	31
Cass v. *Realty Securities Co.*, 148 App. Div. 96, affirmed, 206 N. Y. 649	26
Choate v. *Commissioner*, 324 U. S. 1	35
Collier, Matter of, 112 Misc. 70	26
Commissioner v. *Court Holding Co.*, 324 U. S. 331	34
Commissioner v. *Drovers Journal Pub. Co.*, 135 F. 2d 276	36
Commissioner v. *H. P. Hood & Sons*, 141 F. 2d 467	31, 32
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	22, 26, 27
Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11	31

Cases—Continued	Page
Commissioner v. *Proctor Shop*, 82 F. 2d 792	30, 34
Commissioner v. *Schmoll Fils Associated*, 110 F. 2d 611	25, 27, 38
Crimmins & Pierce v. *Kidder, Peabody Ac. Corp.*, 282 Mass. 367	26
Cring v. *Sheller Wood Rim Mfg. Co.*, 98 Ind. App. 310	26
Deputy v. *duPont*, 308 U. S. 488	36
Dobson v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231	32
Equitable Society v. *Commissioner*, 321 U. S. 560	37, 38
Fidelity Savings & Loan Ass'n v. *Burnet*, 65 F. 2d 477	27
Finance & Investment Corp. v. *Burnet*, 57 F. 2d 444	26
1432 Broadway Corporation v. *Commissioner*, 4 T. C. 1158	31
Gregory v. *Helvering*, 293 U. S. 465	34
Griffiths v. *Commissioner*, 308 U. S. 355	34
Hamlin v. *Toledo, St. L. & K. R. Co.*, 78 Fed. 664	22
Helvering v. *Clifford*, 309 U. S. 331	34
Helvering v. *Morgans, Inc.*, 293 U. S. 121	18
Helvering v. *Stockholms &c. Bank*, 293 U. S. 84	18
Higgins v. *Smith*, 308 U. S. 473	34
Huisking & Co. v. *Commissioner*, 4[illegible] C. 595	31
Jones, Arthur R., Syndicate v. *Commi[illegible]er*, 23 F. 2d 833	31
Kelley, John, Co. v. *Commissioner*, 140 F. 2d 466, No. 36, this Term	17, 31
Kentucky River Coal Corp. v. *Lucas*, 51 F. 2d 586, affirmed, 63 F. 2d 1007	26
Old Colony R. Co. v. *Commissioner*, 284 U. S. 552	36
Pacific Southwest R. Co. v. *Commissioner*, 128 F. 2d 815, certiorari denied, 317 U. S. 663	26
Petit Anse Co. v. *Commissioner*, decided October 27, 1944	31
Spies v. *Chicago & E. I. R. Co.*, 40 Fed 34	23, 39
Staked Plains Trust v. *Commissioner*, 143 F. 2d 421	30, 32
Thomas v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163	24
Union Pacific R. R. Co. v. *United States*, 99 U. S. 402	24
Whitridge v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302	24
Wiggin Terminals, Inc. v. *United States*, 36 F. 2d 893	31
Statutes:	
Internal Revenue Code:	
Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)	2, 10
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	2
Sec. 719 (26 U. S. C. 1940 ed., Sec. 719)	33
Miscellaneous:	
1 Cook, Corporations (8th Ed.) Sec. 273	20
6 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 2645	24
12 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 5447	20
Treasury Regulations 103, Sec. 19.23 (b)–1	3
Treasury Regulations 109, Sec. 30.719–1	32, 34
Treasury Regulations 112, Sec. 35.719–1	33

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OPINIONS BELOW

The opinion of the Tax Court (R. 73–81) is reported in 3 T. C. 95. The opinion of the Circuit Court of Appeals (R. 93–100) and the dissenting opinion (R. 100–104) are reported in 146 F. 2d 809.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 22, 1944. (R. 104.) The petition for writ of certiorari was filed March 22, 1945, and was granted April 30, 1945. (R. 104.) The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether taxpayer corporation was entitled to deduct, as "interest" on "indebtedness" within the meaning of Section 23 (b) of the Internal Revenue Code, payments made during the taxable year to holders of its so-called "registered notes".

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter. [26 U. S. C. 1940 ed., Sec. 23.]
>
> * * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
> (a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section

207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. [26 U. S. C. 1940 ed., Sec. 115.]

* * * * * *

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (b)–1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *

* * * * * *

So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

STATEMENT

Most of the facts were stipulated; others not stipulated were found by the Tax Court from the record made at the hearing before it. (R. 74.)

Taxpayer is a Massachusetts corporation, with principal offices at North Billerica, Massachusetts, engaged in the manufacture of woven woolen and

worsted fabrics. (R. 55, 94.) Taxpayer keeps its books and files its returns on the accrual basis (R. 10); the taxable year involved is the fiscal year ending September 30, 1940. (R. 73.) Prior to the beginning of this fiscal year and prior to any of the transactions out of which the present controversy arose, taxpayer had outstanding as its total capital stock five thousand shares of common stock, par value $100. (R. 74.) This stock was held on September 30, 1939, by 15 stockholders who, with the exception of one holder of ten shares to qualify as a director, were all members of the Talbot family by descent or marriage, or were trusts created by such members. (R. 10, 74.)[1]

For several years prior to 1937 the company had been gradually losing money and in 1937 there was discussion among the stockholders as to liquidation. However, upon the basis of a proposed renovation of plant and changes in personnel, plus possible recapitalization, they decided to continue the business. On May 8, 1939, the treasurer was authorized by corporate resolution "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." (R. 74.) On September 14, 1939, a plan of reorganization was submitted to

[1] All of the stockholders were descendants from three brothers or were married to a descendant of the three brothers. Two of these brothers had founded the business. (R. 62.)

and adopted by the directors and on September 29, 1939, it was approved unanimously by the stockholders. (R. 74.) Pursuant to this plan, each stockholder surrendered four-fifths of his stock which was duly retired by the corporation, and the capital stock accordingly reduced. In return for the stock surrendered taxpayer issued "registered notes", in aggregate face value equal to the aggregate par value of the stock retired. Thus the total amount of the notes issued was $400,000. (R. 74.)

The notes are stated to mature December 1, 1964, slightly more than 25 years from the date of issue. (R. 74–75).[2] They provide for annual interest payable on December 1 of each year, but payment of interest may be deferred by vote of the board of directors for such time as they (R. 75)—

> * * * may in good faith determine to be necessary by reason of the condition of the corporation * * * provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964.

[2] The notes are dated October 2, 1939, but due to delay in printing the notes were not actually signed and delivered to the proper recipients before November 14, 1939. Subject, however, only to this delay in actual delivery they were outstanding in the aggregate sum of $400,000 during taxpayer's entire taxable year. (R. 12.)

They provide for interest at an annual rate ranging from a minimum of two percent to a maximum of ten percent, dependent upon the taxpayer's annual earnings. (R. 75.)[3] The notes

[3] The provisions of the notes in full with respect to interest are as follows (R. 20):

> Interest hereon shall be payable annually on December 1 of each year for and on account of the fiscal year of the corporation ended last previous to such December 1, the first such date for the payment of interest being December 1, 1940, at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows:— There shall be taken a sum equal to two-thirds (2/3ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six percent (6%) per annum, and such interest to December 1, 1964, shall be included in the installment payable at that date.
>
> The corporation shall have the power, by vote of its Board of Directors, to defer the payment of all or part of any annual installment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon such deferred installment of interest, provided that such suspension of payment shall in no wise relieve the corporation of

further provide that no dividends are to be paid on any shares of stock until all then due interest upon the notes, including postponed interest, shall have been paid in full. In the event of bankruptcy, receivership, dissolution or liquidation, principal and interest are to become immediately due, with interest at the rate of six percent from the close of the preceding fiscal year. (R. 75.)

While no mortgage of taxpayer's real estate or of its machinery or equipment, to secure an obligation after December 1, 1964, other than a purchase money mortgage, can be made while the notes are outstanding, without the consent of the holders of three-fifths in interest of the notes, nevertheless, the directors are authorized to subordinate both principal and interest to any indebtedness of the corporation maturing not later than December 1, 1964. (R. 75–76.) The corporation may at any time pay and retire the notes at par, plus accrued interest, except as otherwise provided in any subordination agreement. The notes also provide (R. 76):

> * * * With the written consent of the corporation and of the holders of three-fifths (3/5ths) in amount of the total

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the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964. The corporation covenants that it will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full.

amount of these notes at the time outstanding, filed with the corporation, any of the terms and provisions of this series of notes may be altered or amended so as to bind the corporation and every holder, whether consenting or not, provided that no such change shall:—(a) extend the date for the maturity of the principal of the notes; (b) alter the rate of interest or the method of computing the rate of interest, except in so far as required for an adjustment to a changed fiscal year as above; (c) diminish the principal amount payable at maturity or the amount to be paid upon any earlier payment as above provided; or (d) vacate or diminish the effect of any subordination previously voted and in force.

The Tax Court further found that (R. 80):

> The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. * * * Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock. * * *

Shortly after the plan had gone into effect the "registered notes" on October 10, 1939, by vote of taxpayer's board of directors, were subordi-

nated to two bank loans aggregating $100,000 and a formal subordination agreement was executed. On the same date the notes were also subordinated to a $100,000 machinery loan and to a further $30,000 indebtedness to one of the banks. (R. 76–78.) The subordinations were as to both principal and interest, and those to the banks covered all existing and future indebtedness. (R. 77.) All of the subordinations have since been terminated by payment of the obligations. (R. 78.)

The notes are transferable by endorsement on an attached form, which is required to be authenticated by the clerk of the corporation. (R. 76.) In the year following issue some few totaling $6,800 were transferred, but always within the close family circle. (R. 76.)

On November 27, 1940, taxpayer's treasurer reported that (R. 78):

> * * * he had ascertained and fixed at 10 percent the rate of interest applicable to the registered notes of this Corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 percent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

The report was forthwith accepted and approved. The directors then voted to defer the

payment of three-fourths of the interest which would otherwise be payable on December 1, 1940. On March 25, 1941, this deferment was partially terminated, and on September 15, 1941, wholly terminated, so that in three installments over the course of the fiscal year the total of $40,000 was disbursed.[4] It is the deduction of this amount which the Commissioner contests.[5] (R. 78.) The Tax Court sustained the Commissioner (R. 85) and the court below (one judge dissenting) affirmed the Tax Court (R. 104).

SUMMARY OF ARGUMENT

I

Section 23 (b) allows a deduction for "interest" paid on an "indebtedness." But the legislative history and the regulations make it clear that corporate distributions, however labeled, are not to be deducted as interest where they are essentially dividends.

A. Viewed from any standpoint the instant transaction constitutes an issue of preferred stock. The provisions of the "registered notes" are frequent clauses familiar to preferred stock and the circumstances surrounding their issue and their

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[4] The amount of $40,000 was paid as follows: $10,000 on December 2, 1940; $10,000 on March 27, 1941; $20,000 on September 15, 1941. (R. 9–10.)

[5] The tax deficiencies in controversy are $6,940.15 in income tax and $2,415.73 in declared value excess profits tax. (R. 73, 85.)

treatment since issue further confirm their character as stock. The name borne by the security is of little importance. The substantial legal rights and duties which the instrument creates, read in the light of the surrounding circumstances, are the determining factor, and the misuse of words cannot change the legal conclusions which follow from these rights and obligations.

The income feature bears a close resemblance to capital stock. The interes rate is variable, ranging from a minimum of 2% to a maximum of 10%, dependent upon taxpayer's net earnings. Moreover, at the election of taxpayer, interest payments may be deferred until December 1, 1964, and in conjunction with the written consent of holders of three-fifths in amount of notes at the time outstanding, taxpayer may amend the terms of every note so as to defer interest payment for a further and indefinite period. The payments above 2% are, like dividends, limited to a distribution of net corporate earnings during a given year and are not cumulative. Each of the 15 shareholders retains the same proportionate right to participate in the profits which he had possessed prior to the transaction, and what each shareholder does not receive by way of interest on his "note", he takes by way of dividends on his stock. Again, as in the case of dividends, the distribution is essentially dependent upon th directors' discretion, and the instant agreement, as security for the payment of interest, is actually no more than

the pledge of the good faith of the company in managing its business. Similarly, as with dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation, and other reserves, and what balance remains as net income for distribution to holders of these securities, is unlimited in the absence of bad faith, and a mistake of judgment will afford no ground of complaint. Essentially, a noteholder here, like a stockholder, is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no fixed return upon his money whatsoever. The long continued Treasury Regulations, denying a deduction of "so-called interest on preferred stock, which is in reality a dividend thereon", are here clearly applicable.

Moreover it is immaterial that the instruments on their face do not authorize the noteholders to participate in the management of their business. Such is commonly the case with preferred stockholders. Indeed, here the Tax Court found that the noteholders, a small family group, are identical with the stockholders and are actually the managers of the business, and were, through the directorate elected by them during the taxable year, the persons who determined what portion of the net earnings should be dis-

tributed in the guise of interest and what portion paid candidly as dividends.

Furthermore, the right to repayment of principal investment at a definite time is a proper and not uncommon provision of preferred stock, always subject as here, to the rights of creditors. Thus, taxpayer has unlimited authority to subordinate all of the notes as to both principal and interest to any other existing or future indebtedness maturing not later than December 1, 1964. Hence, these noteholders are no true creditors, but like other proprietors of a business, assume the risk of its every undertaking. Since payment of interest, even as to the minimum of 2%, may be deferred at the "debtor's" option for approximately twenty-five years without incurring liability for interest, there is no real provision for default of nonpayment of interest. Since "maturity" date is fixed twenty-five years in the future, the factor of default upon nonpayment of principal is likewise minimized, and since the agreement enables the debtor to subordinate the noteholders' claims to the rights of all other creditors, the purported maturity becomes comparatively meaningless. Except in taxation, there is no practical difference between preferred stock with or without maturity date and these notes with so-called maturity date.

B. Whether the question presented is considered to turn on its special facts or whether it is considered to be a question of law turning on the

meaning of "indebtedness" as used in the statute, the court below and the Tax Court properly looked to the actualities of the situation in determining whether the corporate distributions were dividends or interest on indebtedness. The Tax Court found that tax avoidance appears to have been the only substantial purpose for the transaction, and what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock. The Tax Court further found that the notes had no business purpose and their issuance brought no new capital into the corporation, but represented a mere exchange which did not in any material way affect the previously existing situation. The court below is clearly sustained by authority in holding that the Tax Court was entitled to consider these circumstances in making its findings.

In any event, if the question here presented is deemed to turn on its special facts, the Tax Court was correct in holding that the payments made were not deductible as interest on indebtedness, and the record amply sustains its finding. On the other hand, if the question whether the contract obligated the payment of "indebtedness" turns on the meaning of that word as used in the statute and is held to be a question of law, the Commissioner contends that these subordinable notes,

bearing variable and deferable interest depending on earnings, do not as a matter of law constitute indebtedness within the meaning of the statute. Moreover, the Tax Court and the court below correctly determined that the circumstances under which the contract was made and the instruments were issued did not involve the payment of genuine interest on a genuine indebtedness. Upon such an issue, namely, the essential nature of a transaction, the finding of the Tax Court, as here, when warranted by the record, is entitled to finality.

II

Finally, the contract does not as a matter of law require the payment of interest. Congress has allowed a deduction only of "interest" and proof that the payment is an "interest" payment remains the primary prescription of the statute. It is not enough for a taxpayer to establish that the indebtedness exists and that a sum, which is not interest, has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". Hence, even assuming *arguendo* that these notes represent an "indebtedness", payments of this uncertain, indefinite and discretionary character geared to corporate earnings cannot as a matter of law constitute "inter-

est" within the meaning of the statute. Certainly, this is true so far as payments in excess of 2% are concerned, and indeed the 2% minimum stands upon no better footing, for not only does it form an integral part of the whole arrangement but payment of the minimum in the case of any noteholder may be deferred indefinitely beyond December 1, 1964, upon the joint election of taxpayer and the holders of three-fifths in amount of notes then outstanding. These so-called interest payments, which are contingent (a) upon the existence of gross earnings; (b) upon their existence during a given calendar year; and (c) upon the exercise of managerial discretion of directors, substantially as broad as that which exists in the case of dividends on stock, have a degree of uncertainty which the notion of interest ordinarily lacks. Certainly they do not satisfy a strict rule of construction, and Congress intended strictly "interest" to be deducted and nothing else.

ARGUMENT

I

THE COURT BELOW PROPERLY AFFIRMED THE HOLDING OF THE TAX COURT SINCE, VIEWING THE TRANSACTION FROM ANY STANDPOINT, IT CONSTITUTES AN ISSUE OF PREFERRED STOCK

The pertinent Treasury regulations and the legislative history of Section 23 (b) of the Internal Revenue Code, allowing a deduction for

"interest" paid on "indebtedness", are considered in the Government's brief in *John Kelley Co.* v. *Commissioner*, No. 36, where it is shown that under the strict rule of construction applicable to such deductions, no allowance is to be given for corporate distributions that are in reality dividends to stockholders. (Pp. 22–27.) It is immaterial that the payments be labeled "interest" on an "indebtedness", and the circumstances of this case, discussed below, amply support the conclusion that the payments out of income on the "registered notes" herein are not deductible as interest on a debt.

The decisions in this field refute the claim made here that all interest upon all indebtedness is deductible. This contention ignores the fact that the words of the statute upon which taxpayer relies are only a part of the Revenue Act and do not fully disclose the purpose of Congress. Therefore, in applying this statute the courts have been influenced by the fact that it is the Congressional policy to distinguish between dividends and interest; that Congress has permitted a deduction for the payment of interest on indebtedness but has withheld a deduction for the payment of dividends to stockholders. Thus the question here is not merely whether any of the rights secured to the holders of these notes is foreign to an indebtedness. Rather, the question is whether any of the rights conclusively earmarks the notes as evidences of indebtedness and distinguishes them from stock certificates.

For the reasons hereinafter stated, we believe there is no single right or combination of rights accorded by these notes which can be said to distinguish the holders from stockholders. Accordingly, the Tax Court was bound to inquire into the circumstances under which these notes were issued.

Taxpayer's assumption (Br. 35–38) that the failure to classify these notes as indebtedness under Section 23 (b) would result in difficulties in applying other sections of the Code is erroneous. If it becomes necessary to classify similar notes under other sections of the Code where the same Congressional policy is not involved, the result might well be different. Cf. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 87. Taxpayer's argument exhibits the same basic fallacy throughout. It attempts to isolate and construe literally a single provision of the Code. This was disapproved in *Helvering* v. *Morgans, Inc.*, 293 U. S. 121, 126, where it was pointed out that the true meaning of a single section of a complex Revenue Act, however precise its language, cannot be ascertained by considering it apart from other sections of the statute and its legislative history.

A. THE PROVISIONS OF THE "REGISTERED NOTES" ARE FREQUENT AND AUTHORIZED CLAUSES FAMILIAR TO PREFERRED STOCK, AND THE CIRCUMSTANCES SURROUNDING THEIR ISSUE AND THEIR TREATMENT SINCE ISSUE FURTHER CONFIRM THEIR CHARACTER AS STOCK

The income features bear a close resemblance to capital stock. The interest rate is variable,

ranging from a minimum of 2% to a maximum of 10%, dependent upon taxpayer's net earnings. Nominally interest is payable annually on December 1st of each year on account of the fiscal year of the corporation ended last previous (September 30th). The rate is computed as follows, subject to the minimum and maximum limitation (R. 20):

> There shall be taken a sum equal to two-thirds (⅔ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars.

Moreover, taxpayer has the power, by vote of its board of directors, to defer the payment of all or part of any annual instalment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon a deferred instalment of interest. (R. 20.) By this provision taxpayer has the power to defer an interest payment on its

own motion to December 1, 1964 (R. 20); moreover, in conjunction with the written consent of the holders of three-fifths in amount of notes at the time outstanding, taxpayer may amend the terms of the notes so as to bind every holder and thus defer the payment of interest for a further and indefinite period (R. 23–24).

The payment of so-called "interest" is not merely dependent upon there being earnings, i. e., gross earnings, but upon there being profit, i. e., "net earnings." The payments above 2% accordingly, are limited exclusively to a distribution of the corporate earnings or profits during a given year. Characteristically such distributions are dividends. As the court said, in *Bakers' Mutual Coop. Ass'n* v. *Commissioner*, 117 F. 2d 27, 28 (C. C. A. 3d):

> The taxpayer argues that even if there was not an unconditional obligation to pay interest on the certificates, certainly there was an obligation to pay the interest if there were profits. But such a distribution of corporate earnings comes within the definition of a dividend in the Revenue Act 1932, § 115, 26 U. S. C. A. Int. Rev. Acts, page 520, and therefore this argument is unavailing.

Further, the payments do not even possess the assurance of preferred dividends,* but like com-

* Preferred dividends, unless express provision is made to the contrary, are cumulative. 1 Cook, Corporations (8th Ed.), Sec. 273; 12 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 5447.

mon stock, dividends (except for the 2% minimum) are not cumulative.

It is apparent, as the court below and the Tax Court respectively pointed out, that each of the 15 shareholders retained the same proportionate right to participate in the profits of the business which he had possessed prior to the transaction, and what each stockholder did not receive by way of interest on his "note" he took by way of dividends on his stock. (R. 80, 97.) On the notes, as on the stock, the noteholder assumes substantially the risks of a proprietor. He is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return (with the exception of the deferable 2%) upon his money, whatsoever.

The taxpayer in the present case has not contracted to pay a fixed rate of interest regardless of whether or not its net earnings are sufficient. Not only is payment deferable but the rate itself is variable depending upon earnings and is determined only after conclusion of the fiscal year. The rate is not fixed in advance, and until fixed is contingent. Thus, it cannot be said that the noteholder has a right to his interest in any event, since he can not know until after the end of the fiscal year what the rate will be, and the notes authorize the directors to suspend the payment of interest even after the rate has been determined when the needs of the business require such action. Indeed, here taxpayer actually deferred

payment of three-quarters of the deduction claimed as interest nominally due December, 1940, and did not make full payment until September 15, 1941. (R. 9–10.) Moreover, no provision is made for interest to be paid on suspended payments and they are subjected to the risks of the enterprise. Interest is a certain payment whose amount is known in advance; dividends are uncertain in amount and there is no absolute right to them. *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182, 187 (C. C. A. 7th). In holding that similar provisions constituted dividends, not interest, the Circuit Court of Appeals for the Sixth Circuit in *Hamlin* v. *Toledo, St. L. & K. R. Co.,* 78 Fed. 664, said (pp. 669–670):

> That these shares are declared to carry "interest at the rate of four per cent. per annum, payable semi-annually, represented by coupons attached," is not conclusive that they are debt obligations. By calling a dividend "interest," the essential nature of the thing is not changed. We must look deeper. When we do so, we find that this "interest" is to be paid only out of "the net earnings" after paying interest upon the first mortgage bonds, "and the cost of maintenance and operation." We further find that this so-called "interest" is "non-cumulative." The net earnings of each year are to be ascertained. If there are none, after paying interest on the first mortgage bonds and operating expenses and expenses of maintenance, no "interest" is to to be paid; and when, at any time, such a

happy state of affairs is found to exist as a surplus, so that anything can be paid upon the current year's "interest," all past due coupons for "unearned interest" are to be surrendered. Thus, this "interest" has all the characteristics of a preference, in dividends to the extent of four per cent. per annum, over the common stock, and none of the marks of interest proper.

Furthermore, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, which, if exercised in good faith, the noteholder cannot control. As said in *Spies* v. *Chicago & E. I. R. Co.*, 40 Fed. 34, 38 (C. C. S. D. N. Y.):

> *An income railway mortgage, * * * is, as a security for the payment of interest, but little more than the pledge of the good faith of the company in managing its lines.* It necessarily contemplates that such improvements as seem necessary to the efficient use and operation of such property, and such alterations in the *corpus* as appear desirable, are to be made, at the discretion of the directors; and unless it contains some limitations upon the powers of the directors, express or implied, the right of the company to conduct its operations as it may see fit, subject only to the conditions of its organic law, is unqualified; and consequently the company can lawfully extend its lines, acquire new ones, discontinue old ones, and thus essentially change the earning capacity of the property. [Italics supplied.]

There are here no contractual restrictions on the power of the directors. Such income payments are further subject to the directors' discretion to retain portions of gross income as reserves against depreciation. *Whitridge* v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302 310 (Md.).

As in the case of dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation and other reserves, and what balance remains as *net* income for distribution to holders of these securities, is unlimited in the absence of bad faith. A mistake in judgment as to the necessity or extent of expenditures will afford no ground of complaint by the security holders. The power of control by the directors, as compared to that existing in the case of stockholders, is substantially unimpaired, and as a practical matter, it is left to them to ascertain whether any of the company's earnings shall be paid to these certificate holders. *Union Pacific R. R. Co.* v. *United States*, 99 U. S. 402, 404, 420–423; *Thomas* v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163, 183–184; 6 Fletcher, *supra*, Sec. 2645. Thus, irrespective of whether "income bonds" may in some instances be considered "indebtedness," we contend that the noncumulative provisions of the instant securities, combined with their other features, establish them to be stock, rather than bonds.

It is immaterial that the instruments on their face do not authorize the noteholder to participate in the management of the business. Such is commonly the case with preferred stockholders. *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. C. A. 2d). Indeed, here the facts which the Tax Court found establish that the noteholders, a small family group, are identical with the stockholders and are actually the managers of the business. Each shareholder retained the precise voice in the management which he had prior to the transaction. (R. 80.) The stockholders retained the same proportionate control of the corporation as owners. (R. 97.) "A very slight fraction" of the notes were negotiated, but remained in the "close family circle". (R. 89.) During the taxable year in question the uncontroverted fact is that the noteholders were the managers of this business and were, through the directorate elected by them, the persons who determined what portion of the net earnings should be distributed in the guise of interest and what portion paid candidly as dividends.

Besides, the provision that taxpayer (R. 20)—

> will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full

a common protection afforded preferred stock-

holders, further establishes the character of these instruments as stock, not debt.[7]

Furthermore, a right to payment at a definite time is recognized as a proper and not uncommon provision of preferred stock, always subject, by implied or as here by express agreement, to the rights of all creditors. The security remains, nevertheless, stock, not indebtedness. *Kentucky River Coal Corp.* v. *Lucas*, 51 F. 2d 586 (W. D. Ky.), affirmed, 63 F. 2d 1007 (C. C. A. 6th); *Finance & Investment Corp.* v. *Burnet*, 57 F. 2d 444, 445 (App. D. C.); *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815 (C. C. A. 9th), certiorari denied, 317 U. S. 663; *Commissioner* v. *Meridian & Thirteenth R. Co.*, *supra*; *Cring* v. *Sheller Wood Rim Mfg. Co.*, 98 Ind. App. 316, 320; *Crimmins & Peirce* v. *Kidder, Peabody Ac. Corp.* 282 Mass. 367, 374–376. The noteholders are here substantially in the position of such preferred stockholders. Thus, taxpayer has authority, by vote of its board of directors, to subordinate all of these notes as to both principal and interest to any other indebtedness of the corporation maturing not later than December 1, 1964, existing at or after the time of such vote. (R. 21.) Indeed, taxpayer exercised this power during the taxable year in question and subordi-

[7] An income "bond" was held preferred stock within the meaning of the New York inheritance tax statute in *Matter of Collier*, 112 Misc. 70, 72–74 (N. Y.), following *Cass* v. *Realty Securities Co.*, 148 App. Div. 96, 100–101 (N. Y.), affirmed, 206 N. Y. 649.

rated the $400,000 of so-called "notes" to $230,000 of debts. (R. 76–78.) In *Fidelity Savings & Loan Ass'n* v. *Burnet*, 65 F. 2d 477 (App. D. C.), where the right of withdrawal existed at any time—not postponed to a date approximately twenty-five years hence—the Court of Appeals of the District of Columbia held the certificate to represent stock, not indebtedness. There also, income was payable out of earnings (p. 480), while the shareholder (p. 481)—

> had, it is true, the advantages of withdrawal which the holder of permanent stock did not have, but this advantage accrued only during the solvency of the corporation.

Commissioner v. *Schmoll Fils Associated, supra; Commissioner* v. *Meridian & Thirteenth R. Co., supra,* pp. 186–187. It follows inescapably that these "noteholders" are no true creditors, but like the other proprietors of the business, assume the risks of its every undertaking.

Moreover, since payment of interest, even as to the minimum 2%, may be deferred at the "debtor's" option for approximately 25 years without incurring liability for interest, there is no real provision for default in payment of interest. Since the maturity date is fixed 25 years in the future, the factor of default upon nonpayment of principal is presently negligible. Besides, since the agreement enables the debtor to subordinate these particular creditors' rights (even 25 years hence) to the rights of all other creditors secured

or unsecured, the purported "maturity" becomes comparatively meaningless.[8] Except in taxation, there is no practical difference between preferred stock with or without maturity date and these notes with so-called maturity date.

B. WHETHER THE QUESTION PRESENTED IS CONSIDERED TO TURN ON ITS SPECIAL FACTS OR WHETHER IT IS CONSIDERED TO BE A QUESTION OF LAW, TURNING ON THE MEANING OF "INDEBTEDNESS" AS USED IN THE STATUTE, THE COURT BELOW AND THE TAX COURT PROPERLY LOOKED TO THE ACTUALITIES OF THE SITUATION IN DETERMINING WHETHER THE CORPORATE DISTRIBUTIONS WERE DIVIDENDS OR INTEREST ON INDEBTEDNESS

The Tax Court found (R. 80-81):

> The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. * * *
>
> * * * what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock.

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[8] The notes are not even afforded protection against the mortgage of fixed assets so long as the obligation secured matures prior to December 1, 1964, and with the consent of three-fifths of the outstanding noteholders the fixed assets may be mortgaged to secure an obligation maturing subsequent to December 1, 1964. This is less security than, by way of covenant against future encumbrance, is often afforded preferred stock. (R. 21.)

Taxpayer has throughout asserted that the notes offered two business advantages to the corporation, first, through reduction in equity control, enabling a concentration of control to effect a stable management, and second, a more negotiable and hence more readily salable security. However, the Tax Court found both these assertions unconvincing (R. 80.) As to the first, it found since each shareholder retained the precise voice in the management which he had prior to the transaction, a pro rata reduction of capital could not facilitate concentrated control, and as a matter of fact did not change the control in the business or in the distribution of its profits. On the contrary, the arrangement was calculated to assure each shareholder that what he did not receive by way of interest, he would take anyhow by way of dividends on his stock. (R. 80.) Thus, taxpayer was able to procure unsecured bank loans at an interest rate of 4% (R. 14); indeed, the notes had to be subordinated to these loans "in order to induce the Banks not to demand payment" (R. 30). At the November 27, 1940, directors' meeting fixing the rate of interest for the taxable year at 10% and deferring payment of three-fourths of it, "the Treasurer reported the ability to pay all bank loans and the arrangement to borrow $400,000 at 3%." (R. 48–49.) As to the second asserted advantage, the Tax Court questioned the additional salability of the "restricted, subordinated, deferable notes" over the original stock.

(R. 80.) In fact, the few notes negotiated ($6,800 out of $400,000), remained within the close family circle. (R. 76.) A finding that these restricted securities issued by this corporation, which throughout its history has constituted the property of a small family unit, are not genuinely marketable or more readily salable than the pre-existing stock, surely finds ample support in the evidence.

The issuance of the notes brought no new capital into the corporation. There was a mere exchange which did not in any material way affect the previously existing interest of the stockholders. The subordinable notes, paying a variable and deferable return dependent upon earnings, were, like stock, geared to the fortunes of the enterprise. Expectation of any return on the investment and the time of payment were dependent upon the prosperity and the convenience of the corporation. The rights and indeed, the identity, of these so-called creditors were assimilated to those of the stockholders. This is not a case where securities originated in borrowing or where they are in the hands of persons distinct from the stockholders. The court below was clearly correct in holding that the Tax Court was entitled to consider these circumstances and all the actualities of the situation. *Commissioner* v. *Proctor Shop*, 82 F. 2d 792, 794 (C. C. A. 9th). To the same effect are *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. C. A. 5th); *John*

Kelley Co. v. *Commissioner*, 146 F. 2d 466 (C. C. A. 7th);[9] *Brown-Rogers-Dixon Co.* v. *Commissioner*, 122 F. 2d 347, 350 (C. C. A. 4); *Huisking & Co.* v. *Commissioner*, 4 T. C. 595, 600;[10] *1432 Broadway Corporation* v. *Commissioner*, 4 T. C. 1158; *Adams* v. *Commissioner*; 5 T. C. No. 40;[11] *Petit Anse Co.* v. *Commissioner*, decided October 27, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,370).[12] Compare *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C. C. A. 7th); *Wiggin Terminals, Inc.* v. *United States*, 36 F. 2d 893 (C. C. A. 1st). But cf. *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C. C. A. 2d); *Commissioner* v. *H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st).

In *John Kelley Co.* v. *Commissioner, supra*, to be argued immediately before the instant case, the transaction closely resembles that involved in the case at bar. There so-called interest also was geared to earnings and depended upon the good faith and managerial discretion of taxpayer's directors. The instruments were also subject to claims of all creditors. Taxpayer was a family corporation and exchange of stock for the alleged

[9] No. 36, this term, to be argued immediately before the instant case.

[10] Taxpayer's appeal pending in the Second Circuit Court of Appeals.

[11] Taxpayer's appeal pending in the Second Circuit Court of Appeals.

[12] Taxpayer's appeal pending in the Fifth Circuit Court of Appeals.

debentures did not affect in any substantial way the previously existing interest for the stockholders. There the method which the Tax Court had expressly employed in testing its fact findings established that its conclusion was arbitrary and amply justified reversal by the Circuit Court of Appeals. The record in the cited case was destitute of evidence to support the finding which the Tax Court had made, and the taxpayer having the burden, the reviewing court properly reversed the order of the Tax Court. The "debentures" there could not as a matter of law constitute indebtedness. Besides, as here, the uncertain, indefinite, and discretionary character of the so-called interest payments limited to corporate earnings could not as a matter of law constitute "interest" within the meaning of the statute. See Point II, *infra*.

In any event, if the question here presented is deemed to turn on its special facts, the Tax Court was correct in holding that the payments made were not deductible as "interest" on "indebtedness", and the record amply sustains its findings. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231; *Commissioner* v. *H. P. Hood & Sons, supra*, p. 471; *Staked Plains Trust* v. *Commissioner, supra*, p. 422.[13] On the other

[13] Compare Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code as amended by the Second Revenue Act of 1940, applicable to the taxable years beginning after December 31, 1939; i. e., to

hand, if the question whether the contract obligated the payment of "indebtedness" turns on the meaning of that word as used in the statute and is therefore to be treated as a question of law, the Commissioner contends that (1) these subordinable notes, bearing variable and deferable interest depending on earnings, do not as a matter of law constitute "indebtedness" within the meaning of the statute; and (2) the Tax Court and the court below correctly determined that the circumstances under which the contract was made and the instruments were issued did not involve

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taxable years subsequent to those here involved, reading as follows (Sec. 30.719–1):

> Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

Section 35.719–1 (d) of Treasury Regulations 112, likewise relating to the Excess Profits Tax under the Internal Revenue Code as amended for taxable years beginning after December 31, 1941, is identical. Section 719 of the Internal Revenue Code, to which this regulation refers, provides for the inclusion in invested capital for excess profits tax purposes of 50% of borrowed capital. The regulation thus follows the court decisions, which have interpreted the interest deduction.

the payment of genuine interest on a genuine indebtedness.[14]

What the law recognizes is an actual, not a merely formal borrowing. *Commissioner* v. *Proctor Shop, supra;* cf. *Gregory* v. *Helvering,* 293 U. S. 465; *Griffiths* v. *Commissioner,* 308 U. S. 355; *Higgins* v. *Smith,* 308 U. S. 473; *Helvering* v. *Clifford,* 309 U. S. 331. As this Court has recently held in *Commissioner* v. *Court Holding Co.,* 324 U. S. 331, 334:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

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[14] Compare Treasury Regulations 109, relating to the Excess Profits Tax, *supra,* fn. 13, reading as follows (Sec. 30.719–1):

> In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit.

The Tax Court, referring to "circumstances surrounding the issuance, to determine the intent of the parties" (R. 80), found that "no proper indebtedness" (R. 81) was created. That finding is entitled to finality on appeal (cf. *Choate* v. *Commissioner*, 324 U. S. 1, 3–4) and brings into play the rule of the *Gregory* and *Griffiths* cases, *supra*, that the Court will look to the essential nature of a transaction, disregarding any steps or legalistic devices having no business purpose other than tax avoidance.

II

THE CONTRACT DOES NOT AS A MATTER OF LAW REQUIRE THE PAYMENT OF INTEREST

Congress has allowed a deduction only of "interest" and proof that a payment is an "interest" payment remains the primary prescription of the statute; it is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". Hence, even assuming, *arguendo*, that these notes represent an indebtedness, payments of this uncertain, indefinite, and discretionary character, geared to corporate earnings, cannot as a matter of law constitute "interest" within the meaning of the statute. Certainly, this is true so far as any payments in excess of 2% are concerned; and indeed, the 2%

minimum stands upon no better footing, for not only does it form an integral part of the whole arrangement, but, as already noted, payment of the minimum in the case of any noteholder may be deferred indefinitely beyond December 1, 1964, upon the joint election of taxpayer and the holders of three-fifths in amount of notes then outstanding. (R. 23.)

This Court has held that "interest" is used in this statute in its "usual, ordinary and everyday meaning" (*Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 561), and that (p. 560) "the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." Again, in *Deputy* v. *du Pont*, 308 U. S. 488, this Court said (p. 498): "We are dealing with the context of a revenue act and words which have today a well-known meaning." Thus, all carrying charges are not interest (*Deputy* v. *du Pont, supra*, p. 497), nor amounts ascribed to a time period prior to the date the loan was made (*Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276 (C. C. A. 7th), although the contract for the use of the money includes a binding promise to pay them. Such agreements do not fall within the ordinary meaning of the term in the context of the statute.

In the context of the Internal Revenue Code and of the long-standing Regulations construing it, so-called "interest", which is in reality a dividend, cannot be deducted. The deduction which

Congress intended was not a contingent, discretionary distribution of earnings and profits, but a fixed and definite charge, known in advance, collectible absolutely, as a debt against the taxpayer's entire assets, in the nature of a cost of the business.

This Court has recently held in *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564, that—

> payments made wholly at the discretion of the company have a degree of contingency which the notion of "interest" ordinarily lacks

even though there (p. 564) "the obligation to pay the principal amount * * * was absolute", and the so-called "interest" was not conditioned on the existence of surplus or earnings. In the instant case the analogy to dividends is more perfect in the respect that 80% of the "interest" payments can be made only out of earnings. In fact, the source is even more limited than is commonly true in the case of dividends, for here the payment may not be made out of surplus or earnings of past years, but is restricted to "the net earnings of the corporation for the fiscal year ended last previous to such December 1". (R. 20.)

Moreover, as also already discussed, the directors' discretion is substantially as broad and untrammeled as that accorded in the case of dividend declarations; in practice, the only dis-

tinction is a formal one. In both cases the amount to be distributed is a balance remaining after the directors have exercised their unlimited judgment in the use of the gross corporate earnings for expenses, repairs, current obligations, and reserves; in the case of the dividend, a formal declaration is necessary, but this, particularly where the stock is preferred, may not arbitrarily be denied. As the Second Circuit Court of Appeals said, referring to similar income provisions (though there cumulative), in *Schmoll Fils Associated, supra* (p. 613):

> Almost the only difference between the debenture holders and holders of cumulative preferred stock is that the former may require payment of their interest out of any net earning of the company, whereas preferred stockholders are able to compel payment of a dividend only in case the directors arbitrarily refuse to declare it.

These so-called interest payments are thus here to a large extent contingent (a) upon the existence of gross earnings; (b) upon their existence during a given calendar year (uncertainties additional to those present in *Equitable Society* v. *Commissioner*, 321 U. S. 560); and (c) upon the exercise of managerial discretion by directors substantially as broad as that which exists in the case of dividends on stock, to permit to remain unexpended a balance of net earnings. They are completely contingent upon the exercise of managerial discretion by directors, similar to that

which exists in the case of dividends on stock, to defer payment for the maximum of twenty-five years, and in conjunction with three-fifths of the noteholders, to defer payment for a longer and indefinite period. Certainly, the instant agreement does not satisfy a strict rule of construction; and Congress intended strictly "interest" to be deducted and nothing else. A deferable obligation, limited largely to distribution of earnings of a given year, which amounts to "but little more than the pledge of the good faith of the company in managing" its business (*Spies* v. *Chicago & E. I. R. Co.*, *supra*, p. 38), does not conform to the businessman's notion of interest, nor fall within the purview of the statute.

CONCLUSION

The decision of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submitted.

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OCTOBER 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945